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In the Supreme Court of the United States

OCTOBER TERM, 1958

NICHOLAS FERRAIOLO, PETITIONER

v.

F. R. NEWMAN

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION AS AMICUS CURIAE

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OPINIONS BELOW

The opinion of the Court of Appeals is reported at 259 F. 2d 342 (Pet. 22–28). The opinion of the District Court (R. 40–43) has not been reported.

JURISDICTION

The judgment of the Court of Appeals was entered on September 24, 1958 (Pet. 28). The petition for a writ of certiorari was filed on December 17, 1958. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether, within the meaning of Section 16(b) of the Securities Exchange Act of 1934, providing that insiders' profits from the purchase and sale of a class

of equity securities within a six-months period are recoverable on behalf of the corporation, a "purchase" of common stock does not necessarily include any acquisition thereof by an insider through conversion of his holdings of preferred stock.

STATUTE INVOLVED

Section 16(b) of the Securities Exchange Act of 1934, 48 Stat. 896 (1934), 15 U.S.C. 78p(b), and Section 3(a)(13) of that Act, 48 Stat. 884 (1934), 15 U.S.C. 78c(a)(13) are set forth at page 5 of the petition.

STATEMENT

Pursuant to Section 16(b) of the Securities Exchange Act of 1934, the petitioner, a stockholder in Ashland Oil and Refining Company ("Ashland"), seeks to recover, on behalf of Ashland, profits of the respondent, a director of Ashland, realized through the acquisition and sale of Ashland's common stock within a six-months period. The common stock of Ashland is listed on the New York Stock Exchange, a national securities exchange (Pet. 26), as was also the preferred stock prior to its redemption. Respondent had acquired 48,092 shares of Ashland's common stock on November 23, 1951, through the conversion of 43,720 shares of Ashland's preferred stock (Pet. 22). On that date, the common stock of Ashland was selling on the New York Stock Exchange at about 33⅛ and the preferred stock was selling at approximately 36¼ (R. 21). The complaint alleges that respondent sold 20,000 shares of Ashland common stock from December 19, 1951 through Jan-

uary 24, 1952, at prices ranging from 36 to 44⅞ (R. 4–5).

In 1948, the respondent had acquired his preferred stock of Ashland and had become a director of that corporation (Pet. 22). The conversion option in the preferred stock contained an anti-dilution provision, and at the time of conversion the ratio was 1.1 shares of common stock for each share of preferred (Pet. 26). During most of the year prior to the conversion, the market price of common stock into which the preferred was convertible (*i.e.*, the market price of 1.1 shares of common) was above the redemption price of the preferred stock (Pet. 26–27). Respondent's conversion followed a notice by Ashland on November 15, 1951, that the preferred shares would be redeemed on December 17, 1951, at the redemption price of $27 a share (Pet. 26).

On demand of petitioner, Ashland instituted this action in the United States District Court for the Northern District of Ohio, and the petitioner intervened. The District Court granted a motion by the respondent for summary judgment (R. 43–44). The petitioner appealed and the Court of Appeals for the Sixth Circuit affirmed (Pet. 28).

ARGUMENT

1. The Securities Exchange Act of 1934 is specifically designed, *inter alia*, "to insure the maintenance of fair and honest markets" in securities transactions (Section 2 of the Act, 15 U.S.C. 78b). Section 16(b) of the Act seeks to implement this general purpose by making it unprofitable for insiders to engage in short-swing speculation. The preamble to the sec-

tion states that it was enacted "[f]or the purpose of preventing the unfair use of information which may have been obtained by * * * [a ten percent stockholder], director, or officer by reason of his relationship to the issuer * * *."

The abuses which led to the enactment of Section 16(b) are discussed in the legislative history of the Act.[1] Among these abuses were transactions in which insiders, with advance knowledge of facts which would produce a rise in the market price of the stock of their company, bought stock at then current market prices and sold it when publication of the information had caused the anticipated rise to occur. There were also transactions in which insiders with advance knowledge of facts which would depress the market price sold their stock at then current prices and repurchased when publication had the anticipated effect. On occasion, the ability to obtain such profits led insiders to manipulate the market price of their stock by causing their corporation to follow financial policies calculated to produce sudden changes in market prices.[2] To prevent such practices in an effective manner, and in view of the difficulty of proving intent

[1] See S. Rep. No. 1455, 73d Cong., 2d Sess. (1934), pp. 55–68; S. Rep. No. 792, 73d Cong., 2d Sess. (1934), pp. 7–9; H. Rep. No. 1383, 73d Cong., 2d Sess. (1934), pp. 13–14.

[2] In its discussion of the proposed Section 16(b), S. Rep. No. 792, 73d Cong., 2d Sess. (1934), states at p. 9:

"* * * Such a provision will render difficult or impossible the kind of transactions which were frequently described to the committee, where directors and large stockholders participated in pools trading in the stock of their own companies, with the benefit of advance information * * *. In a particularly glaring instance, the chairman of the executive commit-

on the part of insiders to speculate on inside information, Congress in Section 16(b) adopted a "rule of thumb"[3] whereby profits from "any purchase and sale or any sale and purchase" of a class of equity securities within a six-months period are recoverable on behalf of the corporation. "Purchase" is elsewhere defined in the Act to include "any contract to buy, purchase or otherwise acquire",[4] and "sale" is defined to include "any contract to sell or otherwise dispose of."[5] The Securities and Exchange Commission is specifically authorized to exempt by rule transactions "not comprehended within the purpose of this subsection."

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tee and another director participated in a pool organized in [*sic*] trade in the stock of their company when the stock was paying no dividends. During the operation of the pool, which continued for a period of 2 years, they caused the company to resume the payment of dividends, more than 25 per cent of which were received by the pool participants. These dividends were paid * * * in spite of the fact that the company's earnings were not sufficient to meet them * * *".

[3] The operation of Section 16(b) was explained by Thomas G. Corcoran, one of its draftsmen, during the hearings which led to its adoption, as follows: "That is to prevent directors receiving the benefits of short-term speculative swings on the securities of their own companies, because of inside information. The profit on such transaction under the bill would go to the corporation. You hold the director, irrespective of any intention or expectation to sell the security within 6 months after, because it will be absolutely impossible to prove the existence of such intention or expectation; and you have to have this crude rule of thumb, because you cannot undertake the burden of having to prove that the director intended, at the time he bought, to get out on a short swing." *Hearings on Stock Exchange Practices*, Senate Committee on Banking and Currency, 73d Cong., 1st Sess., pt. 15 (1934), at p. 6557.

[4] Section 3(a)(13), 15 U.S.C. 78c(a)(13).

[5] Section 3(a)(14), 15 U.S.C. 78c(14).

2. In line with the broadly remedial purpose of Section 16(b), the courts have construed it liberally in a manner calculated "to establish a standard so high as to prevent any conflict between the selfish interest of a fiduciary officer, director, or stockholder and the faithful performance of his duty."[6] Thus, they have applied the statutory definitions of purchase or sale to such transactions as the exercise of stock options granted in consideration of the insider's services,[7] the exchange of stock in a subsidiary for stock of its parent pursuant to a plan of corporate simplification,[8] and the exchange by an insider corporation of stock of its company for stock of its less-than-wholly-owned subsidiary.[9] Consistently, in *Park & Tilford* v. *Schulte,* 160 F. 2d 984, certiorari denied, 332 U.S. 761, the Court of Appeals for the Second Circuit held, in 1947, that the conversion of preferred stock into common stock constituted a purchase of the common stock.

3. We believe that the decision below, holding that here the conversion of preferred stock into common stock was not a purchase of the common stock within the meaning of Section 16(b), is in conflict with *Park & Tilford* and is inconsistent in principle with the

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[6] *Smolowe* v. *Delendo Corp.*, 136 F. 2d 231, 239 (C.A. 2), certiorari denied, 320 U.S. 751.

[7] *Walet* v. *Jefferson Lake Sulphur Co.*, 202 F. 2d 433 (C.A. 5), certiorari denied, 346 U.S. 820; *Blau* v. *Hodgkinson*, 100 F. Supp. 361 (S.D.N.Y.); *Truncale* v. *Blumberg*, 80 F. Supp. 387 (S.D.N.Y.).

[8] *Blau* v. *Hodgkinson*, 100 F. Supp., *supra*, fn. 7.

[9] *Blau* v. *Mission Corp.*, 212 F. 2d 77 (C.A. 2), certiorari denied, 347 U.S. 1016.

other cases referred to above. In our view, the essence of the *Park & Tilford* decision is that any acquisition of a security pursuant to a contract right is, by definition, a purchase.[10]

While the court below found distinctions between *Park & Tilford* and the instant case, we submit that the facts upon which reliance was placed should not be considered relevant to the determination of liability under Section 16(b). One distinction suggested is that the conversion in this case was involuntary, in the sense that the call for the redemption of the preferred stock at a lower price necessitated its conversion to prevent loss. There was also a call for redemption in *Park & Tilford*. The court there pointed out (160 F. 2d at 988) that the "defendants [merely] made an everyday business decision as to the most profitable of three courses of action—redemption, conversion, or outright sale of the preferred."[11] The respondent

[10] See 160 F. 2d, *supra*, at 987:

"We think a conversion of preferred into common stock followed by a sale within six months is a 'purchase and sale' within the statutory language of § 16(b). Whatever doubt might otherwise exist as to whether a conversion is a 'purchase' is dispelled by definition of 'purchase' to include 'any contract to buy, purchase, or otherwise acquire.' § 3(a)(13). Defendants did not own the common stock in question before they exercised their option to convert; they did afterward. Therefore they acquired the stock, within the meaning of the Act. The Act certainly applies as well to executed acquisitions as to executory contracts to acquire. Not otherwise could the Act accomplish the Congressional purpose to protect the outside stockholders against at least short-swing speculation by insiders with advance information. * * *"

[11] See also *Blau* v. *Hodgkinson*, 100 F. Supp. 361 (S.D.N.Y.), holding that an exchange by corporate insiders of stock of a subsidiary for stock of its parent, pursuant to a plan of cor-

here made a similar choice; he elected to convert, rather than to sell his preferred at the then market price or permit its redemption.

The Sixth Circuit below also noted that the insiders in *Park & Tilford* had complete control of the corporation and therefore held the power to determine whether the preferred could be called for redemption. Here there was no showing that the respondent was in control. But the design of Section 16(b) is to eliminate the necessity of proof of control or of the receipt of inside information. As noted by Judge Learned Hand in *Gratz* v. *Claughton,* 187 F. 2d 46, 50 (C.A. 2), certiorari denied, 341 U.S. 920:

> * * * If only those persons were liable, who could be proved to have a bargaining advantage, the execution of the statute would be so encumbered so as to defeat its whole purpose. * * *

The other distinction relied upon below is that the preferred shares in *Park & Tilford* were not the economic equivalent of the common shares into which they were converted, since they were "not protected against dilution" (although there is nothing in the *Park & Tilford* decision so indicating [12]) and were unmarketable, and hence of less value (Pet. 27). But this unmarketability was not referred to in the original *Park & Tilford* opinion; it was mentioned for the

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porate simplification, was not involuntary, since the insiders could have exercised their right as dissenters to demand the cash value of the stock of the subsidiary.

[12] It appears that the absence of such a provision in the Park & Tilford preferred stock was brought to light by an affidavit filed in the District Court in this case (R. 37–38).

first time in connection with the denial of a requested rehearing with respect to the question of damages. 160 F. 2d at 990. In the original decision of the Second Circuit, moreover, it was specifically assumed that the defendant might have effected an "outright sale of the preferred" (see *supra*, p. 7).[13]

In any event, we submit that the preferred shares in this case were likewise not the economic equivalent of the common stock into which they were ultimately converted. They represented interests in Ashland senior to those represented by the common stock and thus provided their holders with a degree of protection against the risks inherent in common stock. Thus, the conversion involved an exchange of essentially different securities. Cf. *Roberts* v. *Eaton*, 212 F. 2d 82 (C.A. 2), certiorari denied, 348 U.S. 827.[14]

While it might well be that the existence of the conversion privilege tends to increase the market value of the preferred stock in proportion to in-

[13] The stock was unmarketable only in the sense that it was not traded on an exchange or otherwise actively traded; and that any public offering would have required registration under the Securities Act of 1933, 48 stat. 74, as amended, 15 U.S.C. 77a, *et seq.* (160 F. 2d at 990). In the original opinion the Court of Appeals assumed that the market value of the preferred was $364,871, the amount found by the District Court and conceded by the parties. *Id.* at 988.

[14] In the *Roberts* case, it was held that receipt of common stock was not a purchase within the meaning of section 16(b) of the Act where it resulted from a reclassification whereby all stockholders received for each share of $5 par value common a package consisting of one share of $1 par value common and one share of $7 par value 40 cents cumulative preferred. The court there noted that the fact that the insiders' position remained proportionately unchanged was "of course an essential for defendants' position". 212 F. 2d at 86.

creases in the market value of the common stock, thus enabling the insider to attain profits without the necessity for conversion, this feature should not immunize short-swing transactions by insiders who do actually convert. The possibility of redemption, inherent in most issues of preferred stock, tends to limit the extent of profits that might be made without conversion, since a prudent corporate management will often redeem where the market price of the preferred goes substantially above its redemption price.[15] Moreover, having had the advantages of a preferred stock—which might include a redemption price in excess of the conversion value in bad times—the preferred stockholder who converts should not be able to claim that, for the purposes of Section 16(b), he is to be treated as having been the owner of the common stock from the start.

Any sale or purchase, whether within six months or not, might be based on inside information. As we have noted, the design of Section 16(b) is by a prophylactic rule to take the profit out of short-term speculation by insiders in the securities of their company, and thus reduce possible instances of misuse of inside information. We see no reason to assume that Congress did not intend the broad definition of purchase and sale in the Act to include the exchange of one class of security for another within the six-

[15] It should be noted that the respondent here could not have obtained the profits involved in this case without conversion, since the rise in the market value of the common stock occurred for the most part after the redemption date (R. 19–21).

months "rule of thumb."[16] Until the decision below, the courts had uniformly interpreted the Act broadly and liberally to support this "rule of thumb." And the Act contains within itself strong indication that the courts are to apply the rule generally, leaving it to the Commission to make appropriate exemptions for transactions which fall within the letter of Section 16(b) but not its spirit. For the last sentence of the section (Pet. 5) expressly authorizes the Commission to exempt, by rules and regulation, any transaction which it deems "not comprehended within the purpose of this subsection."[17]. The transactions involved here have not been so exempted.

4. The importance of Section 16(b) as a means for protecting corporate security holders against incidents of misuse of inside information, described in the legislative history as "most vicious practices,"[18] cannot be indicated by the relatively small number of cases which have been brought under that provision. The very simplicity of the remedy afforded against short-swing transactions—coupled with the requirements of

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[16] Congress evinced specific concern with respect to the grant of options, whereby "manipulative operations" could "be conducted with a minimum of financial risk to the manipulators." H. Rep. No. 1383, 73d Cong., 2d Sess, pp. 10, 11. Like the exercise of other options, exercise of the conversion privilege is susceptible to abuse by insiders who, in the absence of Section 16(b), could hold senior securities with a minimum of financial risk, and at the opportune time capitalize upon the common stock by conversion and sale at a quick profit.

[17] The Commission has adopted such rules. See 17 C.F.R. 240.16b–1, *et seq.*

[18] S. Rep. No. 1455, *supra*, fn. 1, at p. 55.

Section 16(a) for disclosure of all transactions by all officers, directors and 10 percent stockholders—is a powerful deterrent to short-swing speculation by insiders. Since it casts uncertainty on the right of action by the corporation or its stockholders, the determination on a case-by-case basis, as suggested below, of whether or not an exchange of securities is a purchase would tend to reduce the use of the statutory cause of action, and thereby decrease Section 16(b)'s deterrent effect. In addition, any conflict between the circuits in this type of case is especially to be deplored, as corporations subject to Section 16(b) are listed on national securities exchanges and are generally engaged in interstate businesses, a factor which enables suit to be brought in any one of a number of jurisdictions.

CONCLUSION

For the foregoing reasons, we believe that the petition for a writ of certiorari should be granted.

Respectfully submitted.

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